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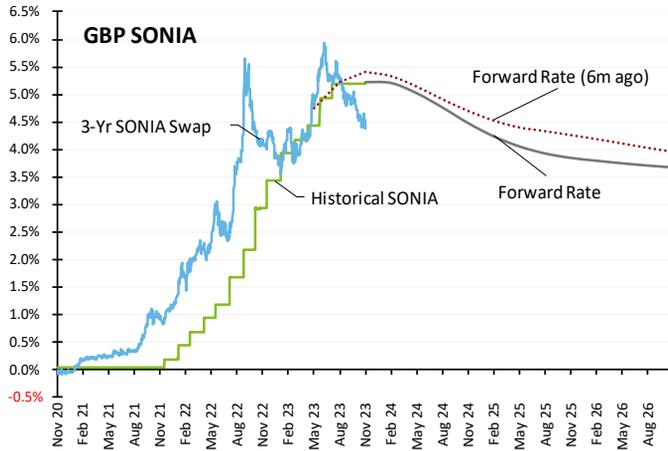
IR and FX Newsletter  
December 2023



## Interest Rate Markets

The monetary tightening cycles for the European Central Bank (“ECB”), Bank of England (“BOE”) and Federal Reserve (“Fed”) have seemingly come to an end. Market expectations for each central bank now suggest rate cuts starting as early as April 2024; the forward curve implies up to 125bps of rate cuts for the ECB and the Fed in 2024, with the BOE anticipated to cut by 75bps.

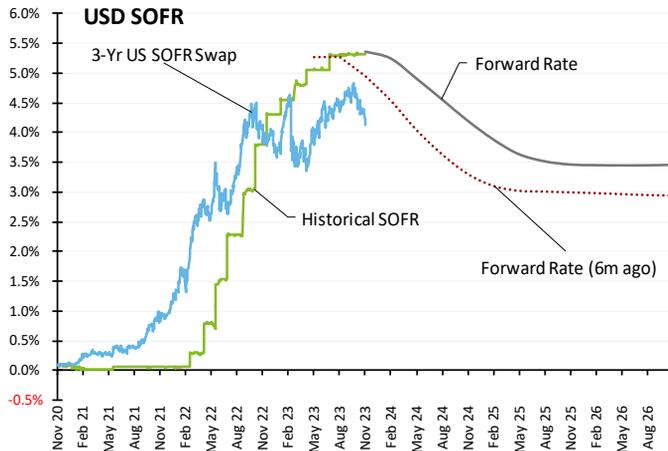
Headline inflation remains the key determinant for rate policy, with the most recent prints reflecting greater than expected drops in the Eurozone, UK and US, all resulting in a steeper inversion of the respective forward curves. Consequently, exchanging floating rate debt for fixed rates via an Interest Rate Swap continues to be far cheaper for longer-dated maturities, as evidenced on page 2.



- The underlying SONIA rate is currently at 5.19%
- BOE base rate is at 5.25% following a pause at the BOE’s meeting on 2<sup>nd</sup> November. Markets now expect no further hikes from the central bank during this monetary cycle.
- The 3-year SONIA Swap rate is 4.43%, vs. 4.82% 6 months ago, and down 28bps month-on-month (“MoM”).
- The forward curve remains downward sloping from Q2 2024.

	2-year	3-year	5-year
Swap rate (mid level)	4.71%	4.43%	4.10%
Cap @ 5.50% (premium)*	£0.43m	£0.86m	£1.86m
Cap @ 6.00% (premium)*	£0.30m	£0.66m	£1.50m

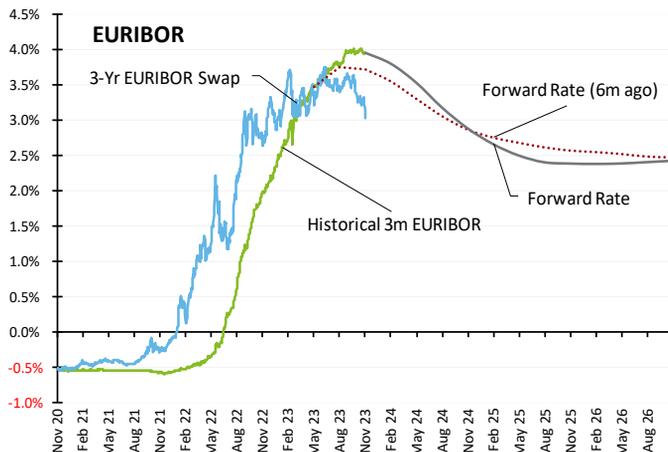
\*£100m hedge notional



- SOFR is currently 5.32%, inside the Fed Funds target rate range of 5.25%-5.50%.
- The Federal Reserve held rates at their meeting on 1<sup>st</sup> November, whilst markets no longer assign any probability of hiking further.
- The 3-year SOFR Swap rate is 4.13%, vs. 3.96% 6m ago, and down 41bps MoM.
- The forward curve is steeply inverted from Q2 2024.

	2-year	3-year	5-year
Swap rate (mid level)	4.45%	4.13%	3.89%
Cap @ 5.50% (premium)*	\$0.26m	\$0.48m	\$1.21m
Cap @ 6.00% (premium)*	\$0.14m	\$0.30m	\$0.91m

\*\$100m hedge notional



- 3-month EURIBOR is 3.96%.
- The ECB held rates at 4.00% at their meeting on 26<sup>th</sup> October. Markets have now almost entirely priced out any further rate hikes from the ECB, with rate cuts anticipated to begin in April 2024.
- The 3-year EURIBOR Swap rate is currently 3.02%, vs. 3.29% 6 months ago.
- The forward curve is inverted from Q1 2024.

	2-year	3-year	5-year
Swap rate (mid level)	3.29%	3.02%	2.86%
Cap @ 4.00% (premium)*	€0.15m	€0.36m	€1.06m
Cap @ 4.50% (premium)*	€0.07m	€0.22m	€0.76m

\*€100m hedge notional

## What can be done in the current Interest Rate markets?



### Borrowers can fix rates below the current floating rate:

Not only is there no additional cost to fix floating rate exposure, but the current downward forward curve allows borrowers to fix rates at levels below the current floating rate:

- SONIA 3m is 5.19% and a vanilla 5y Swap is 4.10%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by **GBP 1.1m**.
- SOFR 3m at 5.34% and a vanilla 5y Swap is 3.89%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by **USD 1.5m**.
- EURIBOR 3m at 3.96% and a vanilla 5y Swap is 2.86%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by **EUR 1.1m**.



### Longer- term hedges are cheaper than shorter-term hedges:

Because of the downward forward curve, long term hedges are cheaper than short term hedges:

- GBP swap: 1-year: 5.15%, 3-year: 4.43%, 5-year: 4.10%
- USD swap: 1-year: 5.07%, 3-year: 4.13%, 5-year: 3.89%
- EUR swap: 1-year: 3.80%, 3-year: 3.02%, 5-year: 2.86%



### Pre-hedging achieves even lower rates:

Pre-hedging future debt (assumed closing is in 6 months) is cheaper than at current hedge rates:

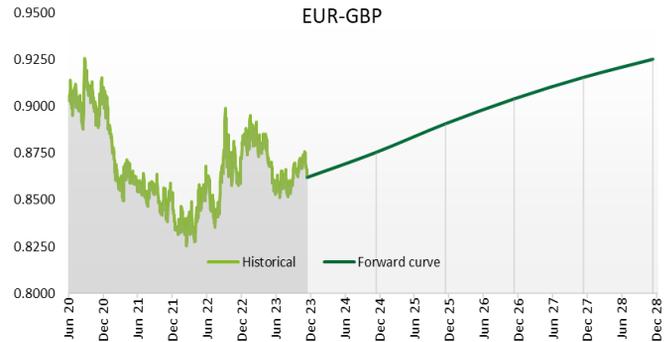
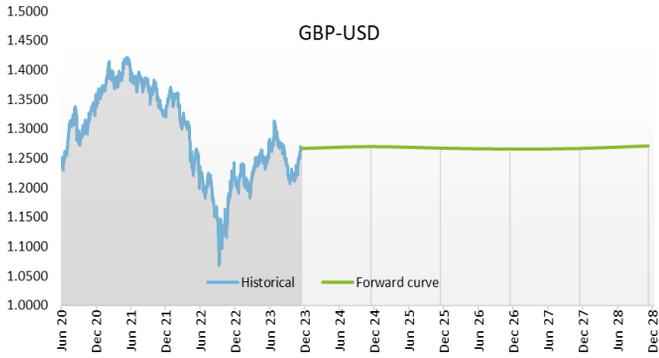
- GBP 5-year Swap starting in 6 months: 3.90%
- USD 5-year Swap starting in 6 months: 3.71%
- EUR 5-year Swap starting in 6 months: 2.64%



### Funding of Hedging costs can be done at favourable rates

Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, EURIBOR or SOFR, without additional margin), rather than via additional borrowing under the facility agreements (at SONIA, EURIBOR or SOFR plus margin).

## Currency Markets



- GBP-USD gained over 4% MoM as falling US Treasury yields and rate expectations lowered the dollar’s appeal. Furthermore, with inflation falling consistently faster in the US than in the UK, markets now price in a more aggressive cutting cycle from the Federal Reserve.
- Option premia fell up to 16% depending on the level of protection, as rate expectations continued to fall and were reflected in a drop in volatility levels.
- Forward FX rates are near enough flat out through 5 years for GBP sellers, suggesting no deviation between interest rate environments across both countries.

- EUR-GBP fell slightly MoM as markets digested better-than-expected inflation data in both jurisdictions.
- The cost of hedging via options for EUR-GBP has fallen significantly, between 5-31%, depending on the level of protection sought – see grid below.
- FX forward rates have steepened for EUR sellers out through 5 years, as markets price in the first rate cut from the ECB for April, and c. 115 bps in total by year-end.

GBP-USD Spot Rate: 1.267	<u>6mo</u>	<u>12mo</u>	<u>18mo</u>
Forward rate	1.270	1.269	1.269
GBP Put Option* (ATMS**)	\$2.54m	\$3.79m	\$4.75m
GBP Put Option* (5% OTMS***)	\$0.76m	\$1.80m	\$2.63m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.267		
*** 5% Out-of-the-money vs Spot rate:	1.203		

EUR-GBP Spot Rate: 0.862	<u>6mo</u>	<u>12mo</u>	<u>18mo</u>
Forward rate	0.868	0.875	0.883
GBP Put Option* (ATMS**)	€2.12m	€3.51m	€4.70m
GBP Put Option* (5% OTMS***)	€0.41m	€1.25m	€2.15m
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.862		
*** 5% Out-of-the-money vs Spot rate:	0.905		

Data source: Refinitiv and ICE Data Services, as of 30<sup>th</sup> November 2023

## Hedging Advisory and Derivatives Execution team



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